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Ms. Jean A. Webb
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

COMMENT

Re: London Clearing House Application for Approval to Operate as a
Swaps Clearing Facility 63 FR 36657 (July 7, 1998)

Dear Ms. Webb:

The New York Mercantile Exchange ("NYMEX" or the "Exchange") appreciates the opportunity to comment, on its own behalf and on behalf of its wholly-owned subsidiary, Commodity Exchange, Inc., to the Commodity Futures Trading Commission ("CFTC" or the "Commission") on the London Clearing House's ("LCH") petition for exemption from most provisions of the Commodity Exchange Act ("Act") in connection with its proposed swaps clearing facility.

The LCH, on its own behalf and on behalf of qualified U.S. entities, has petitioned to exempt the LCH and such entities from most provisions of the Act for clearing by the LCH of "swap agreements," as defined by CFTC Regulation § 35.1(b). NYMEX notes initially that the LCH's proposal, with a few exceptions as noted below, incorporates in many respects the financial and operational safeguards that NYMEX believes should be inherent in any prudently managed clearing facility.

- I. Before ruling upon any particular petition for exemption for the purpose of clearing swaps, the CFTC should first publish for public comment proposed standards for all prospective entities that might petition for such an exemption.

A swaps clearing facility will provide significant benefits to participants using such a facility, including allowing them to reduce the degree of counterparty credit risk in their swaps books. Still, allowing an OTC product to be cleared on a centralized facility would constitute a profound and unprecedented change in how derivatives markets operate. Properly addressing these regulatory responsibilities requires that the

Commission address a host of policy issues.¹ As the CFTC seeks to resolve these and other issues, it is fundamental that the Commission meet its statutory duty by fashioning a regulatory structure that can ensure that exemptions in this area are consistent with the public interest and with the purposes of the Act. NYMEX believes strongly that this duty is best met by issuing such a regulatory proposal for public comment for prospective application generally.² Proceeding in this manner with a level of deliberation that corresponds to the magnitude of the potential impact that the introduction of swaps clearing will have on the marketplace will afford the Commission an opportunity to consider perspectives from many segments of derivatives markets (including the perspectives of experienced OTC market participants).

In this connection, Section 4(c)(2) of the Act provides that the CFTC shall not grant any exemption unless the Commission first makes a series of policy determinations. Specifically, the CFTC must find that: (i) the exemption would be consistent with the public interest and the purposes of the Act; (ii) the transaction would not have a material adverse effect on the ability of the Commission or any regulated exchange to discharge its regulatory or self-regulatory duties under the Act; and (iii) the transaction would be entered into solely between defined "appropriate persons." In this connection, the CFTC Chairperson noted in recent Congressional testimony that "[s]waps clearing and execution facilities pose regulatory issues concerning systemic risk and price discovery that are not involved in privately negotiated, bilateral off-exchange swaps transactions."³ The CFTC Chairperson went on to note that "[a]ny

¹For example, what is the appropriate level of federal regulation of transactions that are conducted between sophisticated market participants but later cleared on centralized clearing facilities? What is the best means of maintaining the integrity of markets and still fostering innovation and flexible markets that respond to the needs of market-users? How may the Commission ensure that its regulatory safeguards for swaps clearing facilities apply equally to domestic and foreign clearing organizations so as to not deter or unnecessarily restrict competition and to not drive business overseas? Also, as discussed below, how should the Commission address the need for even-handed regulation between any new swaps clearing facilities and the regulated futures exchanges?

²Toward that end, in Section II. of this comment letter, the Exchange has included a number of suggestions regarding appropriate safeguards, relating to systemic risk and fiduciary obligations, that it believes that the Commission should consider in formulating its proposed standards for public comment.

³Testimony of Brooksley Born, Chairperson, CFTC, Concerning Over-the-Counter Derivatives Market, Before the U.S. House of Representatives Committee on Banking and Financial Services, July 24, 1998, p. 13.

consideration of permitting clearing and execution facilities must also take into account the need to promote even-handed regulation and fair competition between any such new facilities and existing futures and option exchanges.”⁴

The Exchange agrees with the Commission that clearing facilities do pose concerns about systemic risk. In contrast to a privately negotiated, bilateral off-exchange swaps transaction where the parties to that transaction need only be concerned about the credit risk posed by their respective counterparties, the operation of a swaps clearing facility would entail the pooling or concentration of financial and credit risks from many transactions into one centralized facility. The clearing members generally are not privy to or able to assess the counterparty risks being undertaken by the clearing entity and for which they are collectively responsible. Under Section 4(c), the Commission has a statutory obligation to require that appropriate regulatory safeguards be in place to ensure that such systemic risks have been addressed, so that exemptions will be consistent with the public interest and with the purposes of the Act.

In addition, a swaps clearing facility, like a futures exchange clearing facility (or a bank or insurance company), would collect and hold money from many parties. Thus, it is fair to say that the operation of a swaps clearing facility would raise a number of fiduciary considerations, with regard to the proper maintenance of and accounting for such funds, that should also be addressed through the promulgation of appropriate regulatory safeguards.

Proposing for public comment a regulatory structure that would properly address the many issues raised by swaps clearing facilities would also appear to be necessary to comply with another component of the Commission’s obligations under Section 4(c). As noted, under Section 4(c)(2), the Commission shall not issue an exemption unless, among other things, it makes a determination that exemption of the transaction(s) would not have a material adverse effect on the ability of the Commission or any regulated exchange to discharge its regulatory or self-regulatory duties under the Act. NYMEX agrees with the Chairperson that, in carrying out this responsibility, the CFTC must take into account the need to promote “even-handed regulation and fair competition” between any such new facilities and existing futures and option exchanges. In this regard, in Section IV. of this comment letter, the Exchange offers a few further thoughts on how the Commission might use its exemptive authority to promote even-handed regulation and fair competition.⁵

⁴Id.

⁵The Exchange intends to offer additional thoughts on the CFTC’s use of this exemptive authority in NYMEX’s comment letter to be submitted in response to the CFTC’s over-the-counter (“OTC”) derivatives concept release (“OTC Concept Release”).

Furthermore, the issuance of proposed standards for prospective application, rather than proceeding in a purely *ad hoc* manner, would not only be consistent with the Commission's statutory responsibilities under Section 4(c) but would also be consistent with the Commission's prior practice in issuing Section 4(c) exemptions. By letter dated November 16, 1992, the CFTC received an application for exemptive relief submitted by a group of commercial entities engaged in businesses related to crude oil, natural gas and other energy-related commodities. This group sought exemptive relief for certain contracts involving the deferred purchase or sale of energy products.

The Commission responded shortly thereafter by publishing for public comment a proposed order.⁶ In addition to seeking comment on the application of the statutory requirements for a Section 4(c) exemption, the CFTC also sought comment on the criteria identifying the exempted energy contracts and the eligible commercial participants. The CFTC further sought comment on the netting arrangements that would be permissible under the order. Subsequently, the Commission issued a final order providing exemptive relief that incorporated public comment on the standards contained in the proposed order.⁷

This prior approach is particularly relevant to the LCH's petition because, as noted above, the Commission's review of the energy group's petition included consideration of permissible netting arrangements for the products to be exempted. Therefore, NYMEX submits that issuing proposed standards, either in the context of a proposed order or a proposed rulemaking, would provide a level of due process that is consistent with the degree of regulatory change under consideration. In addition, NYMEX notes that a deliberative regulatory process that provides for notice of the proposed standards for prospective application and an opportunity for comment on such standards would assist the Commission by allowing the Commission and its staff to avail themselves of the experience and expertise in clearing operations of the regulated futures exchanges and also avail themselves of the expertise of sophisticated commercial participants in the swaps markets.

- II. As part of the CFTC's standards for prospective application, the CFTC should propose that swaps clearing facilities be subject to prudent risk management standards which are designed to reduce systemic risk and also be subject to accounting and operational safeguards to support the fiduciary obligations of such facilities.

In the Federal Register release requesting public comment on the LCH's proposal, the Commission sought comment on a significant number of the swaps clearing policy issues raised in the OTC Concept Release. In that release, the CFTC

⁶58 FR 6250 (January 27, 1993).

⁷58 FR 21286 (April 20, 1993).

referred to its 1993 OTC Derivatives Report, in which the Commission stated that the regulatory issues presented by a facility for clearing swaps would depend materially upon the facility's design, such as, for example, the extent to which the operation and practice of such a facility are consistent with the minimum standards for netting systems recommended by the Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries ("Lamfalussy Report"). The Commission sought comment concerning the usefulness of the Lamfalussy standards for swaps clearing facilities.

The Lamfalussy Report set forth the following standards:

1. Netting schemes should have a well-founded legal basis under all relevant jurisdictions.
2. Netting scheme participants should have a clear understanding of the impact of the particular scheme on each of the financial risks affected by the netting process.
3. Multilateral netting systems should have clearly-defined procedures for the management of credit risks and liquidity risks which specify the respective responsibilities of the netting provider and the participants. These procedures should also ensure that all parties have both the incentives and the capabilities to manage and contain each of the risks they bear and that limits are placed on the maximum level of credit exposure that can be produced by each participant.
4. Multilateral netting systems should, at a minimum, be capable of ensuring the timely completion of daily settlements in the event of an inability to settle by the participant with the largest single net-debit position.
5. Multilateral netting systems should have objective and publicly-disclosed criteria for admission which permit fair and open access.
6. All netting schemes should ensure the operational reliability of technical systems and the availability of back-up facilities capable of completing daily processing requirements.

NYMEX believes that these standards are prudent and provide a useful starting point for the standards to be considered by the Commission in the development of swaps clearing facilities. In this regard, the Exchange has a few suggestions concerning the Lamfalussy Report standards.

a. Procedures for management of liquidity and credit risk

Standard #3 refers generally to procedures for the management of credit and liquidity risks. Given the potential for systemic risk to the financial system from

registered transactions, NYMEX believes that it is especially appropriate for the CFTC to propose explicit financial safeguards consistent with sound risk management procedures applicable to regulated derivatives clearing. In particular, the CFTC should require swaps clearing facilities to collect both original and variation margin in cash or cash equivalents and settle on a daily basis using prudent mark-to-market mechanisms. Furthermore, the Exchange believes that firms participating in such facilities, with one exception, should be required to segregate customer funds from their own proprietary funds. NYMEX believes that it would be appropriate for the CFTC to permit an exception to this general requirement if a customer knowingly and willfully determines to "opt out" of this segregation protection.

b. Settlement

While Standard #4 would require daily settlement only in one setting, NYMEX believes that cleared swap positions should be marked-to-market on a daily basis. Privately negotiated swap transactions typically do not require counterparties to remit payments to each other on a daily basis and instead involve an exchange of payments on a more periodic basis, such as at the end of a calendar quarter. However a clearing house that guarantees performance, as it has historically been articulated, is acting as the buyer to every seller and as the seller to every buyer. Accordingly, such a clearing house is assuming a considerable degree of significant financial and, possibly, liquidity risk. To limit its market risk exposure, it is prudent for a clearing house to limit the duration of its exposure until the assets can again be marked-to-market and financially settled. In addition, a longer duration of the time horizon increases significantly the difficulty of engaging in accurate risk measurement of the risk to a clearing house. In addition to requiring daily marking-to-market of positions held at the clearing house, the CFTC also should consider requiring that all variation margin payments be made in cash.

With regard to risk measurement conducted as part of this daily marking-to-market, the CFTC also needs to formulate standards concerning the price basis that will be used as a basis for settlement, particularly for physical commodity contracts. Without such standards, a price basis may be used that would not accurately reflect the true market value of the swap, e.g., due to causes such as cash market illiquidity in the price data being used. This could make the clearing house more vulnerable to increased levels of risk not properly reflected in the variation margin payments. To minimize the likelihood of this outcome, the Commission should formulate appropriate standards. In this connection, even after issuing an exemption for a proposed swaps clearing facility, the Commission would have a continuing obligation to ensure that the prices for these products were not susceptible to distortion (or manipulation) for the protection of the U.S. entities (and their customers) participating in the exempted facility.

Of course, the CFTC has already conducted such an analysis for those contracts that have been designated as contract markets by the CFTC. Accordingly, NYMEX

suggests that the prices of CFTC-approved contracts with sufficient levels of trading volume and open interest should be readily accepted as safe and reliable sources of price data to be used by a swaps clearing house in marking swaps positions to market. In this regard, the Commission should formulate standards relating to the appropriate levels of trading volume and open interest of CFTC-approved contracts for purposes of this risk measurement process.

Other sources of price information, while less preferable, may also be found to be acceptable upon review. Therefore, the Commission also should formulate standards regarding the criteria to be met for alternative sources of price data. NYMEX suggests that such standards might include the reliability of these data sources, the frequency that such data are disseminated, i.e., daily, and the degree of acceptance of such sources by market participants.

c. Criteria for Admission

Standard #5 of the Lamfalussy Report requires that systems have objective and publicly-disclosed criteria for admission which permit fair and open access. This standard is also consistent with Section 15 of the Act, which requires the Commission to endeavor to take the least anti-competitive means of achieving the objectives of the Act. While the LCH's proposal includes prudent financial requirements relating to Swaps Clearing Members,⁸ the LCH's proposal also includes eligibility standards for market participants who would be eligible to have their swap trades cleared through SwapClear. NYMEX finds that these latter eligibility standards are unnecessarily restrictive and would not appear to be the least anti-competitive means of accomplishing the desired objectives.

Specifically, in order for a swap transaction to be cleared through SwapClear, both parties would need to be recognized by the LCH as "Swap Dealers" ("SD"). In order to be so recognized, the LCH proposes to use several criteria. Some of these criteria are reasonable, such as requiring that a prospective SD maintain a Standard & Poors credit rating of BBB or better. However, under other criteria, the LCH effectively would prohibit entities from using SwapClear if those entities were not swaps dealers in the interbank wholesale market and instead were customers or end-users of such swap dealers. This prohibition would hold regardless of the size, financial integrity, or

⁸The LCH proposes to require that its Swaps Clearing Members, among other things, own at last one member share in the LCH (at a cost of approximately £300,000), contribute to the LCH's Member Default Fund, and either be a Swaps Dealer (as that term is defined in the LCH's proposal), a subsidiary of a Swaps Dealer or have financial resources of at least £250 million.

experience in swaps transactions of an end-user.⁹

NYMEX believes that the Commission's standards should clarify that the appropriate analysis for determining eligibility for participation in a swaps clearing facility should involve primarily the financial integrity and commercial standing of the entity and, perhaps, prior experience by that entity with swaps transactions. It is inappropriate for public markets to exclude, because of their line of business, entire classes of possible participants who otherwise qualify as appropriate persons under Section 4(c) and Regulation 35.

d. Recordkeeping Requirements

The Exchange suggests that the Commission's proposed standards should include some form of recordkeeping requirement. At a minimum, the CFTC should specify a level of recordkeeping that would be consistent with the fiduciary obligations of the swaps clearing facility and that could be reviewed as part of the ongoing auditing of the facility. Indeed, clearing entities of the organized futures exchanges are required to maintain appropriate records detailing all transactions effected through such entities. We can think of no essential difference in the function, duties or risks undertaken by a swaps clearing organization that would reduce the need for the maintenance of such records. Thus, for example, the CFTC might require that, as a condition for exemption, such a facility would maintain records on the essential terms of the swaps transactions being cleared as well as on all exchanges of payments, including margin flows, associated with each transaction.

e. Reservation of Right to Review Exemptions

Finally, the Exchange believes that it is important generally for the Commission, when issuing any grant of a petition for Section 4(c) exemptive relief, to clarify that the CFTC reserves the right to review that exemption from time to time and also reserves the right subsequently to modify or even terminate the exemption when the CFTC deems that it is necessary to do so. Of course, the CFTC should further clarify that any

⁹Thus, for example, Merrill Lynch and J.P. Morgan, which presumably could both qualify as SDs, could enter into a swap transaction and obtain the benefit of reducing their counterparty credit risk with each other by posting the transaction with the LCH. However, in the event that Merrill Lynch entered into a swap transaction with Shell Oil, it would appear that Shell Oil would not qualify as an SD, even though it is a large, well-capitalized and sophisticated commercial entity. Merrill Lynch and Shell Oil may have an interest in reducing credit risk for their transaction that is at least as strong as that of Merrill Lynch and J.P. Morgan. However, in the swap trade between Merrill Lynch and Shell Oil, as Shell Oil would not qualify as an SD, the trade could not be posted with the LCH and neither of these counterparties could thus obtain the benefit of reducing their counterparty credit risk.

such modification or termination would only be undertaken prospectively by the Commission.

- III. In the event that the CFTC should determine to provide exemptive relief for swaps clearing facilities, it should ensure that there is consistency in regulatory treatment between such clearing facilities and the clearing facilities of futures exchanges.

As stated above in section I., the standards to be established by the Commission for exemptive relief for proposed swaps clearing facilities should be equally applicable to both domestic and foreign clearing facilities. In addition, NYMEX believes that the CFTC should ensure that there is consistency in regulatory treatment between swaps clearing facilities and the clearing facilities of futures exchanges.

Many of the products that potentially might be cleared through a swaps clearing facility, whether domestic or foreign, have terms that are very similar to products traded on regulated domestic futures exchanges. Hence, swaps clearing facilities and the OTC markets, which such facilities would serve, can be viewed as markets that compete with as well as complement regulated futures markets. In the event that the CFTC should eventually permit the operation of swaps clearing facilities, a major benefit now being offered exclusively by regulated futures exchanges, i.e., the elimination of counterparty credit risk, would now be available for those products to be cleared by the swaps clearing facilities. Prior to such a change, market participants seeking the elimination of counterparty credit risk also had to accept the trade-off of the substantially higher regulatory costs and higher degree of regulatory scrutiny associated with trading on futures exchanges. If swaps clearing is approved without providing even-handed regulatory treatment in relation to the regulated futures exchanges, a futures exchange will become a less desirable marketplace for conducting business, since the elimination of counterparty credit risk will now be available elsewhere.

- IV. To promote even-handed regulation and fair competition between OTC markets and regulated domestic futures exchanges, the Commission should undertake a review of its regulation of futures exchanges.

As previously noted, in the CFTC Federal Register release seeking comment on the LCH's petition, the Commission sought comment on the general policy issues relating to swaps clearing posed in the OTC Concept Release as well as on the LCH proposal. NYMEX believes that an important lesson can be learned from the experience of the explosive growth of the OTC markets. These markets have functioned outside of a carefully circumscribed system of regulation in an efficient manner and, by providing unique and innovative financial tools, have significantly contributed to the promotion of the public interest without significant systemic problems.

NYMEX believes that such an approach could be used in regulation of the futures markets in that certain existing regulatory requirements hinder the ability of

futures markets to respond effectively in a rapidly-evolving marketplace. In this regard, the grant to the CFTC of exemptive authority under Section 4(c) does not distinguish between exchange and off-exchange transactions. In other words, in 1992 Congress not only gave the CFTC authority to exempt OTC transactions but also provided it with express statutory authority to exempt exchange transactions from relevant provisions of the Act.

At present, heavily regulated domestic futures exchanges face competition from less regulated OTC markets. In addition, as the acceptability of electronic trade matching continues to broaden, domestic futures exchanges also must face the challenges posed by a growing number of electronic trading systems, including systems domiciled outside of the U.S. NYMEX believes that market-users are best served when they can choose from a number of competing services, and the Exchange is developing strategic initiatives to respond to changes in the marketplace. However, the absence of significant regulatory relief could impact upon the continuing viability of domestic futures exchanges, would be inconsistent with the CFTC's regulatory obligations under the Act, and, as noted below, could compromise the CFTC's basis for exercising jurisdiction.

NYMEX respectfully submits that a major, if not the central unfinished challenge, that remains to be met by the CFTC is to apply the exemptive authority granted by Congress to exchange-traded transactions with the same creativity and vision that it has displayed for the OTC markets. The CFTC's prior efforts in this area have been so limited in scope that they have never been used by any of the regulated domestic futures exchanges. As the global financial community continues to shrink, a failure by the Commission to undertake a serious review of the appropriate level of regulation of domestic futures exchanges could result in more and more business being done offshore. This consequence would undermine the CFTC's ability to exercise its jurisdiction even in situations where the pricing integrity of domestic products has been compromised.

Therefore, there is an urgent need for the Commission to undertake a review of its regulation of domestic futures exchanges. In this regard, the Exchange notes that the implementation of swaps clearing facilities would result in a further integration of exchange and off-exchange trading activities. The Exchange believes that, at a minimum, the CFTC should defer action in this area until an innovative proposal that also would further integrate exchange and off-exchange trading activities, namely NYMEX's proposal to permit the exchange of futures for swaps ("EFS"), has been considered for action to the Commission. The Exchange's EFS proposal has languished at the Commission staff level for several years and deserves to be acted upon immediately.

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In closing, before ruling upon any particular petition for exemption for the purpose of clearing swaps, the CFTC should first publish for public comment proposed

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standards for all prospective entities that might petition for such an exemption. Simply put, a level playing field is best maintained when all players know the rules of the game at the beginning of the match. The Commission's proposed standards should establish prudent risk management requirements to address systemic risk and also address the fiduciary obligations created through the operation of swaps clearing facilities. In addition, these standards should be consistent for both foreign and domestic entities generally and consistent specifically with the regulatory treatment of the clearing facilities of domestic exchanges so as to promote fair competition through even-handed regulation. Finally, and perhaps most critically, the Commission should undertake in a timely manner a serious and far-reaching review of the current level of regulation of domestic futures exchanges, with an eye toward reducing unnecessary regulatory burdens wherever possible.

NYMEX thanks the Commission for the opportunity to submit comments concerning the LCH application and would be pleased to furnish additional information in this regard. If you have any questions, please do not hesitate to contact the undersigned.

Respectfully submitted,



R. Patrick Thompson
President

cc: Chairperson Brooksley Born
Commissioner Barbara P. Holum
Commissioner James E. Newsome
Commissioner David D. Spears
Commissioner John E. Tull, Jr.